No. 15,273

IN THE

United States Court of Appeals

For the Ninth Circuit

PACIFIC VEGETABLE OIL CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF OF PETITIONER.

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PRELIMINARY STATEMENT.

Petitioner respectfully refers the Court to its opening brief for statements regarding jurisdiction and other relevant matters. It is intended that this Reply Brief will discuss primarily the Brief of the Respondent and the case of *Earle v. Woodlaw* decided by this Court on February 28, 1957 (1957, C.C.H. Par. 9472), some eight days after the filing of Petitioner's Opening Brief.

THE TAX COURT ERRED AS A MATTER OF LAW IN DECIDING THAT THE DISTRIBUTIONS MADE BY THE CORPORATION IN THIS CASE WERE ESSENTIALLY EQUIVALENT TO A TAXABLE DIVIDEND. THE TAX COURT DECISION IS CLEARLY ERRONEOUS, BEING CONTRARY TO THE EVIDENCE, AND SHOULD BE REVERSED.

It is of course generally held that the question of whether a corporate distribution is a liquidating dis-

tribution under Section 115(c) of the Internal Revenue Code or is essentially equivalent to the distribution of a dividend under Section 115(g) is a question of fact.

Nevertheless, when the answer to a question, nominally one of fact, is dependent upon the legal interpretation of, and the application of, statutory regulations and decisions, the inquiry moves into the realm of law, not fact. Thus, the cases are in equally general agreement that the ultimate conclusion reached by a Trial Court on such a question can be reversed when clearly erroneous, which necessarily involves the concept of error of law as applied to the facts before the Court.

This case presents a typical example. In the Findings of Fact and Opinion of the Tax Court (T.R. 77), the Court makes the "finding" that the distribution in question in this case was a distribution in partial liquidation and not a distribution "essentially equivalent to the distribution of a taxable dividend" (T.R. 102). Although designated as a Finding of Fact, it is impossible to avoid the conclusion that this finding is at least a combined finding of fact and conclusion of law, if not purely a conclusion of law (Cf. *Thornley v. C.I.R.,* 147 Fed. (2d) 416; *Earle v. Woodlaw,* 1957 C.C.H., Par. 9472, Pg. 56,899). It is thus completely reversible if erroneous as a matter of law or as an application of the law to the facts involved.

The petitioner contends that the Tax Court erred as a matter of law and should be reversed in that it failed properly to consider all of the "judicial criteria" established by the decided cases in this field,

failed to give proper weight to important factors in the case, failed to interpret the facts correctly in the light of judicial precedent and statutory provisions and finally, failed to base its decision upon substantial evidence.

There are certain definite factors which are relevant in distinguishing between a distribution which constitutes the essential equivalent of a taxable dividend under Section 115(g) and a distribution which constitutes a partial liquidation under Section 115(c). Accordingly, we shall discuss these factors as they apply to the facts in this case, and will show how the Tax Court, in improperly considering the evidence, was clearly erroneous in its findings and conclusions and ultimately in its decision.

Merely because the Tax Court asserted in its opinion that it had considered all relevant factors cannot preclude review and reversal. For a litigant to be barred on appeal by such a formula would result in the Trial Court's immunity from reversal upon a mere self-serving assertion. Surely this is not a tenable proposition.

AS JUDGED BY THE "JUDICIAL CRITERIA" LAID DOWN BY THE COURTS, THE DISTRIBUTION IN THIS CASE SHOULD BE HELD TO BE ESSENTIALLY EQUIVALENT TO A DIVIDEND AND THE TAX COURT FAILED TO PROPERLY CONSIDER AND APPLY THESE CRITERIA.

In the very thorough decision of this Court in *Earle v. Woodlaw,* decided February 28, 1957, C.C.H. Par. 9472, the Court reversed the Trial Court's decision

which had held that a distribution similar to the one in the instant case had been in partial liquidation. In arriving at this result the Court, in an opinion written by Judge Barnes, considered the various "judicial criteria" which have proven useful in coming to a conclusion as to whether Section 115(g) is applicable.

As this opinion is the latest pronouncement of this Court with respect to this question and in an effort to assist the Court in arriving at its decision in this case, Petitioner will now consider the factors mentioned in *Earle v. Woodlaw*.

1. Did the corporation adopt any plan of contraction of its business activities?

The answer here is obviously that it did not. Both before and after the distribution Western's activities were maintained at substantially the same level (T.R. 24). In 1948 Western crushed 25,304,012 pounds of copra, in 1949 (the year of the distribution) 38,249,-910 pounds, in 1950, 33,875,264 pounds, in 1951, 47,-581,862 pounds, in 1952, 38,907,292 pounds, and in 1953 (four years after distribution) Western crushed 26,021,450 pounds of copra, more than the crush of 1948. It is evident that there was no contraction in Western's principal business, namely copra crushing. Respondent concedes this in its Brief at page 21.

Moreover, Western continued to maintain in succeeding years all of its plant and equipment and, as shown by Exhibit 10-J (T.R. 43), Western's gross sales actually increased materially after 1948.

Concerning this factor, in its Opinion the Tax Court merely states that in order to be a partial liquidation it is not necessary that the corporation be planning a cessation of business or be in the process of final liquidation (T.R. 116-117). Such a sideward glance can hardly be called "recognition" of the factor of lack of contraction of Petitioner's business as claimed by Respondent (Brief page 21). The Tax Court did not discuss contraction but only complete cessation. The Tax Court was clearly erroneous in its consideration of these facts and should be reversed.

2. Did the corporation follow an orderly procedure looking toward its ultimate dissolution, or its ultimate contracted operation?

Again, the answer here is obviously that it did not. The corporation continued to operate after the distribution in question and in the year 1951 earned $106,037.90 as compared to a profit in 1948, the year prior to the distribution, of $88,573.88 (T.R. 43). Thus, it can be seen that a greater profit was made after the distributions than prior thereto and, as mentioned above, on a larger volume of business. It was not until 1954, five years after distribution, that unforeseen severely adverse conditions in the copra industry forced Western to discontinue its business.

3. Did the initiative for the corporate distribution come from the corporation, based on usual business considerations, or did it come from the stockholders, for their own purposes?

In the instant case no corporate purpose was served by the distribution of accumulated profits, but rather the shareholder solely was served by having accumu-

lated earnings not needed for the business distributed to it. The corporation retained ample working capital with which to carry on its business (T.R. 42).

Respondent in its Brief (page 25) asserts that the corporate minutes in the case of each distribution and cancellation expressly state that such action was to the best interests of the corporation. At best such a statement in the corporate minutes is purely routine and commonly made in respect of any action by directors involving corporate assets. It does not constitute any evidence of any particular corporate purpose and should be judged in the light of the actual needs of the corporation and the stockholders.

Petitioner contends that it is apparent from all the evidence in the record, including the large amount of earned surplus, the wholly adequate working capital, the expanding business and the paucity of dividends, that the shareholder's purpose was being served by this distribution and not the corporation's. There simply are no actual business considerations revealed in the record which would indicate that any business purpose was served by the distribution, whereas the record is replete with considerations pointing to the fact that the purpose of the stockholders was served.

4. Is the proportionate ownership of stock by the shareholders changed?

Though the proportionate ownership of stock among all shareholders was changed, the essential relation of the *Petitioner* to the distributing corporation, as a practical matter, remained the same after the redemp-

tion as before. This test, which was adopted by the Court in *Commissioner v. John T. Roberts,* C.A. 4th Cir., (1953), 203 F. 2d 304, is met in this instance. The Court in that case stated at page 306:

> "that by the redemption of this stock the *essential relation* of the taxpayer to the corporation was not, in any practical aspect, changed."

In Respondent's own rulings, as pointed out in our Opening Brief, (page 19) the test is that of the *Roberts* case. Respondent devotes a great deal of attention to this aspect of this case and insists that the Tax Court was justified in considering that a significant change had occurred in the taxpayer's relationship to the corporation. The Tax Court specifically found and held in its Opinion (T.R. 115) that Petitioner's relationship to Western was essentially changed. This simply is not the fact.

Prior to these distributions and redemptions, Petitioner, without combining with either A. A. Schumann or other minority shareholders, was unable to control the corporation. After the redemption, Petitioner, without combining with A. A. Schumann, was unable to control the corporation. Petitioner's essential relationship to the corporation thus was not, in any practical aspect, changed. The Tax Court and Respondent are clearly in error in their analysis of this relationship. The test, as the *Roberts* case shows, is not one of precise mathematical proportion, but of "essential" change as a "practical matter." The rationale of this criteria is that if, as a practical matter, the taxpayer has the same basic relationship with the corporation

after a distribution as before, the distribution is equivalent to an ordinary dividend, which, of course, leaves the shareholder in the same position after as before the dividend. In the instant case, the shareholder, Petitioner, was in the same position after as before the distribution relative to the distributing corporation. Though the precise structure of the stock holdings in the distributing corporation changed, the essential relationship of Petitioner to the corporation had not changed in any practical sense.

5. What were the amounts, the frequency, and the significance of dividends paid in the past?

From 1935 through 1949, a period of fifteen years, Western had paid ordinary dividends in eleven of those years, but without regularity. An ordinary dividend was paid in 1949 of $10.00 per share, amounting to $50,491.00 (T.R. 41). However, even though paying dividends Western had accumulated large amounts of earned surplus amounting to $768,299.64 in 1948 (T.R. 42), an amount far in excess of all dividends paid in all its history. As Petitioner was able to conduct its business in 1950, after the distribution, at an increased rate of sales on an earned surplus of only $129,315.93 (T.R. 42, 43), it is apparent that the accumulation in 1948 was excessive. As this Court pointed out in *Earle v. Woodlaw,* the declaration of dividends over a period of years is not significant if an unreasonable amount of earned surplus is also being accumulated. The Court also pointed out that this seems to meet the indicia discussed in *Commissioner v. Roberts,* 4 Cir., 203 F. 2d 304, where there

was a finding that "there had been an accumulation by the corporation for no definite purpose; that there was on hand a large and unnecessary accumulation of cash representing earnings."

Respondent, in its Brief (page 23), asserts that the Tax Court did not base its main reliance on this factor of dividend payments. Petitioner contends that the Tax Court not only did rely heavily upon this factor but also that the Tax Court clearly erred in its consideration of the factor, in that it did not consider them in relation to the large accumulation of earned surplus nor in the light of the decided cases.

6. Does the capitalization at the time of the cancellation of the stock represent capital paid in, or earnings?

The record shows that at the time of the cancellation of the stock the capitalization of Western was represented by a capital stock account of $62,300.00, a paid-in surplus account of $69,090.00, and an earned surplus account of $768,299.64 (Dec. 31, 1948, T.R. 42). After the cancellation the respective figures were $62,300.00; $69,090.00, and $129,315.93 (T.R. 42).

7. Was there a sufficient amount of earned surplus to cover the distribution, or was it purely capital?

The record is absolutely clear on this question. The distribution was from accumulated net income, classified as earned surplus on the books of the corporation (Respondent's Brief 20-21). The Tax Court's "recognition" of this factor (T.R. 117) can hardly be held to be more than a statement of a broad undeniable

rule. It certainly was not a discussion of the existence of earned surplus and its meaning in this case.

8. Was there a maintenance of a relatively similar amount of capital liability, or did that figure decrease to a degree somewhat comparable to the purported distribution of capital?

In the instant case the capital account of Petitioner was the same on its balance sheet both before and after the distribution in question. In this respect, the distribution was again essentially equivalent to a dividend. The Tax Court does not "recognize" this factor once in its opinion.

9. Was there good faith, or bad, in the action of the Board of Directors?

There is no evidence in the record bearing upon the question of the good faith of the Board of Directors.

10. What was the net effect of the actions taken?

This test, the most important of all the above tests, dictates that if all purchases of its own stock by a corporation taken together, accomplish the same result as the declaration of a dividend, a gain derived by a stockholder therefrom is taxable as a dividend.

In *Earle v. Woodlaw* this Court quoted the legislative history as contained in *Hyman v. Helvering,* D.C. Cir., 71 F. 2d 342, in the following language at page 344:

> "Suppose . . . the case of two men holding practically the entire stock of a corporation for which each paid $50,000.00. The corporation having accumulated a surplus of $50,000.00 above its cash capital, buys from the stockholders for cash one-

> half of the stock held by them, and cancels it, and the payment is non-taxable because it is a partial redemption of stock. To change this result and make it taxable Section 115(g) was written and incorporated into the law."

This example is applicable to the instant case.

This Court, again in *Earle v. Woodlaw,* quotes from the case of *Smith v. United States* (3 Cir., 121 Fed. (2d) 692, 695) as follows:

> "The answer within the intendment of (g) turns, not so much upon the question of whether there was or was not liquidation, as upon the result."

In the instant case the Tax Court and the Respondent are more concerned with the question of whether there was a liquidation rather than with the net effect, or the result, of the transactions.

Petitioner acknowledges that *all* of the factors mentioned in its Brief and above have some degree of relevance. However, it also asserts that certain of the factors should be weighed more heavily in determining the net effect of the transactions than others. Certainly the fact that other Courts have consistently considered some factors of more significance than others should be of importance. And even though it is undoubtedly true that cases cited as precedent can be distinguished on their facts (it is hard to imagine two perfectly similar cases in such a complex field), these precedent cases are valuable as an aid in determining the applicable law. These cases set up the "judicial

criteria'' that Judge Vinson referred to. Without these criteria an appellant would find it impossible to show error in appealing a decision of the Tax Court in which the Tax Court has stated that it has considered all the factors, when in fact it has considered only a few and has passed over lightly those usually considered of major importance. Petitioner contends that it is reasonable to assign to certain of the factors considered above more weight than to others in light of the relatively long and thorough judicial history on this question. Surely the guideposts set down by other courts as to what is important in determining what is a dividend can reasonably be given some weight and can be turned to by the Appellate Court to aid in determining if, in light of the evidence, the Tax Court is clearly erroneous, whether as a matter of law or fact.

Finally, a contention that Respondent makes in its Brief at pages 13-14 implies that the use of Section 115(g) is limited to those cases wherein the government is attempting to tax a partial liquidation as a dividend and is not available to a taxpayer for the purpose of tax reduction. Such a limitation does not exist and should not exist. The application of Section 115(g), as all parties have admitted, turns on the facts of each case. The inquiry should be simply whether there was a taxable dividend or not, as judged by reasonable criteria. Certainly the inquiry should not be into the fact of whether the taxpayer will avoid taxes or not.

In *Fostoria Glass Co. v. Yoke* (D.C.W.V. 1942), 45 F. Supp. 962, the distribution in question was made to

a corporate shareholder and the Court found the distribution to be "essentially equivalent to a dividend" within Section 115(g). The application of Section 115(g) resulted in a substantial reduction in the tax payable due to the applications of the dividends-received credit, to which the taxpayer as a corporation was entitled in view of the distributions having been the equivalent of a dividend.

In *Commissioner v. Forhan Realty Corporation* (C.C.A. 2d 1935), 75 F. 2d 268, the taxpayer, a corporation, surrendered its stock in another corporation, receiving cash and other securities therefor. The taxpayer, being a corporation, was not then taxable on dividends received. The Court of Appeals for the Second Circuit held nevertheless that the distribution should be treated as a dividend, even though the result was that no tax was paid. The Court said in 75 F. 2d, at page 269:

> "Where the section refers to a distribution which 'has the effect of the distribution of a taxable dividend,' 'taxable dividend' is to be considered from the viewpoint of the corporation making the distribution, and, where the distribution has the effect of what is ordinarily considered a taxable dividend, from the distributing corporation's viewpoint, section 112(c) (2) is applicable to the entire distribution, without regard to whether there is a possibility of parts of the distribution going to some distributees which parts, if viewed as ordinary dividends, would be nontaxable to such distributees either because the distributees are corporations or because they have not sufficient income to be subject to surtax."

CONCLUSION.

Under the circumstances outlined above, it is Petitioner's view that this reviewing Court should be left with a definite and firm conviction that a mistake has been made in the decision of the Trial Court. It is submitted that the ultimate conclusion of the Tax Court was clearly erroneous and should be reversed.

Dated, San Francisco, California,
April 30, 1957.

Respectfully submitted,
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